

Office of Chief Counsel
Internal Revenue Service
memorandum

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from: Area Counsel, LMSB Area 1 (Financial Services)

subject:

I.R.C. § 6694 Penalty
U.I.L. Nos. 6694.01-00 and 6694.02-00

This memorandum responds to your request for assistance dated December 28, 2002. The national office has reviewed and concurred with the advice rendered herein. This memorandum should not be cited as precedent.

LEGEND

Taxpayer	=
Preparer	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
Time Period 1	=
Date 1	=

INTRODUCTION

You have requested our advice on asserting a section¹ 6694 penalty against Preparer for making an impermissible election for a reduced credit under section 280C(c)(3) ("section 280C(c)(3) election"). This memorandum discusses Preparer's return preparation activities for Taxpayer.

FACTS

Preparer specializes in advising clients on issues related to the section 41 credit for increasing research activities ("research credit").

On its original tax returns for its Year 1, Year 2, Year 3 and Year 4 taxable years, the Taxpayer did not claim the research credit. Subsequent to filing its returns for these taxable years, the Taxpayer hired Preparer to review its activities, books and records for the purpose of claiming research credits on amended returns. During Time Period 1, Preparer provided the Taxpayer with a research credit study. The study does not caution the Taxpayer that it is only an example of how the Year 1, Year 2, Year 3 and Year 4 taxable years could have been treated. On Date 1, the Taxpayer used this study to file claims for refunds for its Year 1, Year 2, Year 3 and Year 4 taxable years. The preparation of the study was supervised by a Preparer partner

In the research credit study, Preparer outlined its methodology for identifying the Taxpayer's qualified research expenses ("QREs") and computed the Taxpayer's research credit, using the actual figures for research expenditures and other items for each of the years in question. When computing the research credit in the study, Preparer used a section 280C(c)(3) election. The numbers from the Preparer study were mechanically placed on the Forms 1120X filed with the Service. Preparer rendered advice which is directly relevant to the determination of the Taxpayer's entire claims for refund made on these Forms 1120X. Preparer did not sign the Taxpayer's refund claims as a preparer, and at this point, we do not know whether Preparer or Taxpayer actually prepared the amended returns. As a result of Preparer's computation, the Taxpayer attempted to make a section

¹ Unless otherwise noted, all section references are to the Internal Revenue Code of 1986, as amended.

280C(c)(3) election on the refund claims it filed with the Service.

The Taxpayer's attempt to make a section 280C(c)(3) election resulted in understatements of the Taxpayer's income tax liability for the Year 1, Year 2, Year 3 and Year 4 taxable years. That is, the attempted section 280C(c)(3) election resulted in the Taxpayer claiming refunds greater than the refunds it could have claimed if it did not attempt to make the election.

ISSUE

Should the Service consider asserting the section 6694 penalty against Preparer for advising the Taxpayer to make an impermissible section 280C(c)(3) election on a refund claim?

CONCLUSION

Since Preparer is a "return preparer" who advised the Taxpayer to take a frivolous position (i.e., to make a section 280C(c)(3) election, for the first time, on a refund claim after a timely original return was filed) that resulted in a tax understatement, the Service should consider the asserting the section 6694 penalty against Preparer.

APPLICABLE LAW

A. Sections 41, 174 and 280C

Section 41 allows taxpayers a credit against tax for increasing research activities. Generally, the credit is an incremental credit equal to the sum of 20 percent of the excess (if any) of the taxpayer's QREs for the taxable year over the base amount, and 20 percent of the taxpayer's basic research payments determined under section 41(e)(1)(A).² Section 174(a) provides that a taxpayer may treat research or experimental expenditures that are paid or incurred during the taxable year in connection with the taxpayer's trade or business as expenses not chargeable to capital account.

Section 280C(c)(1) requires taxpayers to reduce the amount of QREs otherwise allowable as a deduction under section 174 by an amount equal to the research credit determined under section 41(a). However, section 280C(c)(3) allows a taxpayer to make an election that will allow it to avoid the reduction of the section

² Under section 41(c)(2), however, the minimum base amount is 50 percent of the credit year QREs.

174 expenditures. Specifically, a proper section 280C(c)(3) election enables a taxpayer to avoid the reduction of section 174 expenses by claiming a reduced research credit generally equal to 13 percent of the excess of a taxpayer's QREs for the taxable year over the base amount. I.R.C. § 280C(c)(3)(B).

Section 280C(c)(3)(C) specifically provides that the section 280C(c)(3) election shall be made not later than the time for filing the return of tax for such year (including extensions), shall be made on such return, and shall be made in such manner as the Secretary may prescribe. This rule is repeated in Treasury Regulation § 1.280C-4(a), which states "[t]he election under section 280C(c)(3) to have the provisions of section 280C(c)(1) and (2) not apply shall be made by claiming the reduced credit under section 41(a) determined by the method provided in section 280C(c)(3)(B) on an original return for the taxable year, filed at any time on or before the due date (including extensions) for filing the income tax return for such year." (Emphasis added).

B. Section 6694

i. General Rules

Section 6694(a) and (b) impose penalties on income tax return preparers for certain understatements of liability on a return or claim for refund. An "income tax return preparer" is a person who prepares, for compensation, any return of tax imposed by subtitle A (income taxes) or any claim for refund of taxes imposed by subtitle A. A person who does not physically prepare an income tax return is considered a preparer if that person furnishes a taxpayer sufficient information and advice so that completion of the return or claim for refund is largely a mechanical matter. Treas. Reg. § 301.7701-15(a)(1).

For purposes of section 6694, no more than one individual associated with a firm (e.g., a partner or employee) may be treated as a return preparer with respect to the same return or claim for refund. Treas. Reg. § 1.6694-1(b)(1). Generally, the individual with overall supervisory responsibility with respect to the return or refund claim is treated as the preparer for penalty purposes. Id. An employer or partnership of an individual return preparer subject to an sections 6694(a) and/or (b) penalty is also subject to penalty as a firm if:

- (1) one or more members of the principal management of the firm or branch office participated in or knew of the proscribed conduct;
- (2) the employer or partnership failed to provide reasonable and appropriate review procedures; or
- (3) such review procedures were disregarded.

Treas. Reg. §§ 1.6694-2(a)(2) and 1.6694-3(a)(2).

ii. Section 6694(a) Penalty

Section 6994(a) provides that a return preparer may be liable for a penalty in the amount of \$250 if:

- (1) any part of an understatement of liability with respect to a return or claim for refund is due to a position that did not have a realistic possibility of being sustained on its merits;
- (2) the return preparer with respect to that return or refund claim knew or reasonably should have known of the unrealistic position; and
- (3) such position was not adequately disclosed in order to avoid the accuracy-related penalty for understatement of income tax or was frivolous.

The penalty will not be imposed, however, where there is reasonable cause for the understatement and the preparer acted in good faith. I.R.C. § 6694(a). The return preparer has the burden of proving that the preparer did not know and had no reason to know that the questioned position was taken on the return, there was reasonable cause for the position taken, and that such position was maintained in good faith or that the position was adequately disclosed. Treas. Reg. § 1.6694-2(e). Under Treasury Regulation section 1.6694-2(c), adequate disclosure is made in accordance with the rules for the substantial understatement component of the accuracy-related penalty provided in Treasury Regulation section 1.6662-4(f). Disclosure is adequate under the regulations only if made on a properly completed form (Form 8275, Disclosure Statement) or in accordance with an annual revenue procedure (e.g., Rev. Proc. 94-36, 1994-1 C.B. 682 for Year 1993 returns).

A position is considered to satisfy the realistic possibility standard if a reasonable and well-informed analysis by a person knowledgeable in tax law would lead that person to conclude that the position has approximately a one-in-three, or greater, likelihood of being sustained on its merits. Treas. Reg. § 1.6694-2(b)(1).

Adequate disclosure of an unrealistic return position is a defense to the section 6694(a) penalty. However, adequate disclosure is not a defense when the return position is frivolous. Treas. Reg. § 1.6694-2(c)(1). A frivolous position is one that is patently improper. Treas. Reg. § 1.6694-2(c)(2). The test for frivolity is an objective one, which must be evaluated in terms of the position's legal underpinnings. McKee

v. United States, 781 F.2d 1043, 1047 (4th Cir. 1986), cert. denied, 477 U.S. 905 (1986).

If the preparer shows that an understatement was due to reasonable cause and the preparer acted in good faith, the preparer penalty for a position that does not satisfy the realistic possibility standard will not be imposed. This is a facts and circumstances determination made with reference to the nature of the error, the frequency and materiality of the errors, the preparer's normal office practice, and reliance on another preparer's advice. Treas. Reg. § 1.6694-2(d).

iii. Section 6694(b) Penalty

A \$1,000 penalty may be imposed on a return preparer who:

- (1) willfully attempts to understate the tax liability of another person on a return or in a claim for a refund, or
- (2) recklessly or intentionally disregards rules and regulations.

I.R.C. § 6694(b).³

Treasury Regulation § 1.6694-3(b) provides that a preparer is considered to have willfully attempted to understate liability if the preparer disregards, in an attempt wrongfully to reduce the tax liability of the taxpayer, information furnished by the taxpayer or other persons. Treasury Regulation § 1.6694-3(c) provides that a preparer is considered to have recklessly or intentionally disregarded a rule or regulation if the preparer takes a position on the return or claim for refund that is contrary to a rule or regulation and the preparer knows of, or is reckless in not knowing of, the rule or regulation in question.

The Service bears the burden of proving that a return preparer willfully attempted to understate the tax liability. However, the return preparer bears the burden of proving that no rule or regulation was recklessly or intentionally disregarded, that any position contrary to a regulation represented a good faith challenge to the validity of the regulation, and that disclosure was adequately made. Treas. Reg. § 1.6694-3(h).

The terms "rules and regulations" are defined to include the provisions of the Internal Revenue Code, temporary or final

³ With respect to any return or claim, the amount of the penalty payable by any person by reason of Section 6694(b) shall be reduced by the amount of the penalty paid by such person by reason of Section 6694(a). I.R.C. § 6694(b).

Treasury Regulations issued under the Code, and revenue rulings or notices (other than notices of proposed rulemaking) issued by the Service and published in the Internal Revenue Bulletin. Treas. Reg. § 1.6694-3(f).

Adequate disclosure of an understatement due to willful, reckless, or intentional conduct is a defense to the section 6694(b) penalty. Treas. Reg. § 1.6694-3(c)(2). Under Treasury Regulation section 1.6694-3(e), adequate disclosure is made in accordance with the rules for the substantial understatement component of the accuracy-related penalty provided in Treasury Regulation section 1.6662-4(f)(1), (3), (4) and (5). Disclosure is adequate under the regulations only if made on a properly completed form (Form 8275, Disclosure Statement). However, adequate disclosure is not a defense to the Section 6694(b) penalty if the return position is frivolous. A frivolous position is one that is patently improper. Treas. Reg. § 1.6694-2(c)(2).

Treasury Regulation section 301.7701-15(a)(1) provides that if a person furnishes a taxpayer or other preparer enough information and advice to make completing the return or claim for refund largely a mechanical or clerical matter, the person is considered an income tax return preparer, even if he or she does not actually place or review information on the return or claim for refund.

Revenue Ruling 85-189, 1985-2 C.B. 341, applies Treasury Regulation section 301.7701-15(a)(1) to a person, X, who created a computer program that taxpayers purchased to prepare and print a Form 1040 for tax year 1983. The computer program explained the requirements for each entry on the return and then the taxpayer entered figures. X designed the computer program so that taxpayers could use it even if they were not familiar with the provisions of the Code and regulations.

The revenue ruling explains that the determination of whether X is considered the preparer of a tax return does not depend on whether X or X's employees personally reviewed a completed return or whether X or X's employees actually placed any of the figures on the return. Rather, such a determination depends on whether X has given substantive tax instructions in the computer program. X is considered a preparer with respect to returns because X's computer program provides more than mere mechanical assistance. Substantive determinations are performed by X's computer program concerning the application of section 48(q) of the Code to the factual information supplied by a taxpayer.

The revenue ruling predates the realistic possibility standard; at that time the section 6694(a) penalty was imposed for a negligent or intentional disregard of the rules and

regulations, but it remains relevant for determining who is a preparer under the present section 6694.

DISCUSSION

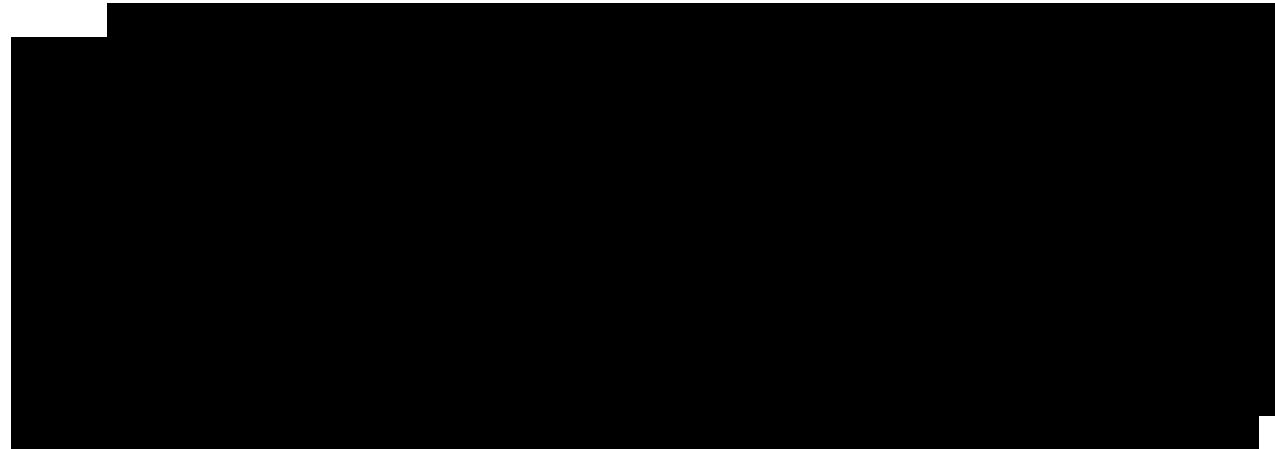
A. Sections 6694(a) and 6694(b)

The facts of this case clearly warrant consideration of the imposition of the section 6694(a) and 6694(b) penalty because:

- Preparer's research credit study formed the basis of the Taxpayer's Forms 1120X. Thus, Preparer is a return preparer. Treas. Reg. § 301.7701-15(a)(1); see also Rev. Rul. 85-189.
- At the time Preparer produced its study, it was already too late to file section 280C(c)(3) elections for the years at issue. Yet the study provided to the Taxpayer used figures for those years without any indication they should not be used in a claim for refund.
- Making a section 280C(c)(3) election on a refund claim, if not properly elected on the timely filed return for that taxable year, contravenes the plain language of the code and regulations and is, therefore, frivolous and demonstrates Preparer's reckless disregard for the income tax rules and regulations.
- The untimeliness of the filing is evident on its face to a person familiar with the law; nevertheless, it has not been disclosed in accordance with the regulations under sections 6662 and 6694. Moreover, since making a section 280C(c)(3) election for the first time on a refund claim is frivolous, there is no "adequate disclosure" defense under sections 6694(a) or 6694(b).
- The attempted section 280C(c)(3) election resulted in understatements of income tax.

There is a reasonable cause defense to the section 6694(a) penalty (not the section 6694(b) penalty). Preparer would bear the burden of establishing reasonable cause. Given the expertise and experience of Preparer with the research credit and the fact that Preparer used actual figures for tax years for which the Taxpayer ultimately submitted claims, we believe it would be extremely difficult for Preparer to establish reasonable cause for failing to comply with a simple procedural requirement that is readily apparent from the plain language of the Code.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS



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If you have any questions, please contact [REDACTED] at [REDACTED] or [REDACTED] at [REDACTED].

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